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PRODUCTION SHARING AGREEMENTS: LEARNING LESSONS FROM RUSSIA AND NIGERIA

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ABSTRACT

This paper lays the foundation of what Production Sharing Agreements are, what they were intended to be, and how they have failed to meet the current requirements of the State and, in turn, have ended up exploiting the economic resources of the countries by not giving the State their rightful due. Moreover, this paper highlights the consequences of implementing the Production Sharing Agreements in two major oil producing States namely Nigeria and Russia. Subsequently, an earnest attempt has been made to bring to light the flaws of the Production Sharing Agreements accompanied with the inefficiency of the States to amend their respective laws according to their economic requirements.

Keywords: Oil; Production Sharing Agreements; Nigeria; Russia; Energy Law

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1. INTRODUCTION

For a successful petroleum regime, the government must design and implement an appropriate legal regime comprising special petroleum laws, regulations, and model production sharing contracts or model licenses, depending on the government's preference.[1] It should also consider petroleum taxation, State participation in exploitation, treatment of foreign investors and imposition of production restrictions if needed to fulfil international obligations in this respect.[2] Many governments lacking the technology and fund for oil exploration and exploitation are compelled to turn to Foreign Oil Companies (FOC)[3] that hold most of the financial and technical means needed for the exploration and exploitation of petroleum resources. Therefore, an enabling legal and fiscal framework, to act as catalyst, and, more importantly, as surety for the inflow and preservation of new, and typically foreign, investment, must be implemented[4]. This framework creates Petroleum Agreement, thereby creating a legal relationship between the State and the petroleum company that describes the rights and corresponding obligations of each party for each stage of petroleum resources, by aiming to provide security, which will give effect to the symbolic relationship between the parties.[5] Not to be left out are the establishments of administrative infrastructure comprising a specialized ministry, a petroleum directorate and a supervision entity.[6]

Every State has sovereign powers over their natural resources including hydrocarbon resources existing at the surface or in the sub -surface of its land territory or its continental shelf.[7] By virtue of these powers, the legislature can make laws authorizing the government of the country to regulate petroleum extraction activities within its jurisdiction. As a rule, ownership of petroleum resources is vested in the State. However, there are exceptions where separate property rights with respect to minerals are acknowledged[8] and such situations exist in the Unites States where the landowner is also the owner of the petroleum on the surface of or beneath the land.[9]

States adopt oil policies to develop and establish their domestic petroleum production, for economic and strategic reasons. Economically, domestic production affords States' opportunity to participate in production

1 Benard Taverne. '*Petroleum, Industry and Governments: An Introduction to Petroleum regulation, economics and government policies'* (2000) Springer Publication, United Kingdom 89.
2 *Ibid* p.88.
3 Herein after referred to as FOC.
4 O. O. Rewane, *'Creating a comprehensive and Investor Friendly PSA Regime: Where does Russia Keep Going Wrong*?' (2005) 3 OGEL 29.
5 *Ibid*.
6 *Supra* n.5.
7 Art. 1, United Nations Convention of the Continental Shelf 1958 and UNCLOS 1982.
8 Benard Taverne. '*Petroleum, Industry and Governments: An Introduction to Petroleum regulation, economics and government policies'* (2000) Springer Publication, United Kingdom 89.
9 *Ibid*.

operations, export surplus oil to increase its balance of payment and yield government tax revenue[10]. Strategically, domestic production guarantees energy security of the States to a large extent by diminishing the dependence on foreign oil suppliers making a State economically and politically vulnerable.[11] A State setting up its legal regime for petroleum production within must take into account a few aspects of international law because the State may be or may become a party to[12] global or regional conventions e.g., UNCLOS 1982, OPEC, Bilateral Inter-State Agreements, Multilateral Inter-State Agreements, etc. These conventions and treaties impose, *inter alia*, on the member States, restrictions and obligations with respect to petroleum operations under its jurisdiction.[13]

Production Sharing Agreement (PSA) is a contractual arrangement made between a foreign oil company – FCO (contractor) and a designated state enterprise (state party), authorising the contractor to conduct petroleum exploration and exploitation within a certain area (contract area) with the understanding that, from the petroleum subsequently produced, the contractor will be entitled to a portion called profit oil in addition to another portion called recovery oil.[14] PSAs are essentially a sole risk contract for the FOC.

PSAs in the modern form were first introduced in Indonesia on the 18th of August 1966 by Dr. Ibru Sutowo, founder, first President and Director of Pertamina in order to redefine the role of the State and FOCs, which had previously been on a concessionary system.[15] Dr. Ibru Sutowo, in evolving this system, 'tried to find a system reasonable for Indonesia and yet worthwhile for companies to gamble their money'.[16] In essence, he was looking for a system, which gives Indonesia reasonable profit but, at the same time, puts the responsibility and risk of funding on FOCs. Dr. Ibru Sutowo formulated 5 fundamental principles for future agreements with foreign oil companies, which gained wide acceptance in Indonesia and beyond.[17] These principles are:

1. The State enterprise would have management control.
2. The Contract would be based on production sharing instead of profit sharing.
3. The Contract would bear the production risk and cost recovery would be limited to 40% of the annual production.
4. The remainder production (after cost is deducted) would be split 65/35 in favour of the government.

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10 *Supra* n.10.
11 *Supra*
12 *Supra*
13 B. Taverne, note 92.
14 Bernard Taverne, 'Production Sharing Agreements in Principle and Practice' in David M.R. (Ed) Upstream Oil and Gas Agreements (1996) Sweet and Maxwell, London 44.
15 O.O. Rewane, 'Creating a Comprehensive and Investor friendly PSA Regime: where does Russia keep going wrong?' (2005) 3 OGEL 9.
16 *Ibid*
17 *Ibid*

5. Title to equipment purchased by the contractor would pass to the State enterprise upon entry to Indonesia.

Thus, PSA was first introduced in Indonesia in 1966 in response to increasing criticism and hostility towards the concession system at that time.[18] PSAs tend to favour small, poor, developing and transitional countries with potential oil reserves[19] and this is because the countries lack the financial resources and technical expertise to efficiently locate and extract their oil, and therefore, contract with the FOCs to locate and extract the oil on behalf of the State for a share of the production.[20]

Under the PSA, the FOC is entitled to recoup its capital cost once the project is producing oil, and this is called as the cost oil.[21] The percentage of capital cost oil that the FOC is allowed to recoup can range from 20 to 100 percent, but 30 to 60 percent is more common.[22] The remaining oil, minus royalties and bonuses paid to the State based on the total production, is the profit oil.[23] The ways of calculating the profit oil share can be extremely complex. They can be straight splits of the profit oil, or it can be determined by sliding scales based on the projects' rate of return.[24] Outside the profit oil, the government also has royalties, taxes and bonus schemes as a way of increasing direct revenue of the State.[25] As a result of these additions, most PSAs provide a total government's take that ranges between 75 to 90 percent of the projects' total revenue.[26]

The amount of a host government's take under a PSA is a telling factor in whether or not a country is competitive in attracting foreign investment.[27] The ability of the host government and its National Oil Company (NOC)[28] to work in harmony with the FOC after they have reached to an agreement is very important because the cooperation between the host government, its NOC and the FOC is essential in PSAs as both parties have ownership of the production and management decisions.[29] It is noteworthy to state that PSAs are basically regulated by domestic laws. However, this is done in accordance with the international law[30] and the comprehensive treaty in this regard is the EECT.[31]

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18 Kristen Bindemann, 'Production Sharing Agreements: An Economic Analysis' (1999) Oxford Institute of Energy Studies 10.

19 Thomas W Walde. 'The Current Status of International Petroleum Investment: Regulating, Licencing, Taxing and Contracting' (1995) 1:5 CEPMLP Journal.

20 D. Babusiax and others, 'Oil and Gas Exploration and Production Reserves, Costs, Contracts' (2004) 17 Editions Technip 199.

21 *Ibid* p.200

22 *Supra* n.21

23 Nutavoot Pongsiri, 'Partnership in Oil and Gas Production Sharing Contracts' (2004) 17:5 The International Journal of Public Sector Management 432-434.

24 *Ibid*.

25 *Supra*.

26 Bindemann, note 19 p.18

27 King and Spalding LLP, note 13 p. 3.

28 Herein after referred to as NOC

29 *Supra* n.27.

30 Bernard Taverne, note 19 p.54

31 European Economic Treaty 1957 Art 18.

As a result of the economic and political importance of hydrocarbon resources to States, PSAs are formulated to uphold State sovereignty over its natural resources and ensure that the States are not financially involved in petroleum operations as it is a sole risk venture.[32] PSAs also aim at providing States lacking financial resources and technical experience to build their domestic petroleum industry by relying on the FOCs to provide them with the needed financial resources and technical capabilities for this purpose as well as transfer of technology by training the national employees and State party personnel.[33] With PSAs, the State can maximise revenue from its hydrocarbon resources through royalties, taxes, bonus schemes and profit oil.[34]

2. WHAT OIL COMPANIES WANT

Generally, oil companies prefer exclusive licence/ concession to risk contracts and PSA to other types of risk contracts.[35] However, in practice, oil companies have no choice in the matter as it is the prerogative of the host government to decide its oil policy. Nevertheless, the FOCs look out for the following interest when negotiating contracts:[36]

1. A right to oil reserves: FOCs want a deal that guarantees their right to extract the reserves for many years, thus ensuring their future growth and profits. They also want a contract that allows them to 'book' these reserves, including them in their accounts increasing their company value. PSAs like concession contracts permit oil companies to book reserves in their accounts. The importance of this to oil majors should not be underestimated. In 2004, Shell was found to have overstated the size of its 'booked' reserve by over 20% and it lost the faith of the financial market impacting heavily its share price and credit rating.[37]
2. An opportunity to make large profits: Oil companies make their profit from investing and risking their capital. In some cases, they lose their capital e.g., when they drill a 'dry well'. However, they make good gain when they find large and hugely profitable fields. Oil companies aim for deals that give them a chance to make super profit and PSAs are designed to allow oil companies to achieve very large profits if successful.
3. Predictability of tax and regulation: While oil companies can accept exploration risk (when no oil is found), or price risk (the oil price falls), both being beyond their control, they try to manage 'political risk' by locking in government in binding long term contracts that fix the terms of their investments. PSAs could range from 20 to 40 years with terms

32 *Ibid* p. 57
33 *Ibid* p. 49-50
34 Bernard Tavern, note 19 p. 45
35 *Ibid* p. 44
36 Greg Muttitt. Crude Designs: The Rip-Off of Iraq's Oil Wealth
37 *Ibid*.

protected from potential change by incoming regimes of the governments.

As a result of these enticing objectives of the PSA, many developing countries and States interested in exerting control over their hydrocarbon resources opt for PSAs as part of their oil development policy. In theory, the objectives of PSAs are quite enticing such that most developing States fall for it, but PSAs leave the States worse of. One underlining objective of PSAs is to revitalize the economy of a State, create employment by training personnel and nationals; but most States find the FOCs wanting in this aspect. PSAs are essentially a risk contract of the FOCs because they bear the exploration and financial risks, while in fact it is the State bearing the risks. States have entrusted their hydrocarbon resources into the hands of FOCs who are very much interested in the exploration and exploitation of the State. More so, the States have no knowledge of how much hydrocarbon they have, and they need to accept what FOCs disclose the amounts to them. It then means, they (FOCs) are very much in control of the resources, and it is a risk worth taking since every investment (and more) will be recovered to the detriment of the State.

PSAs hit the very foundation of the economic revenue of the States. Most States that implement PSAs are heavily dependent on their resources; and, even though they have other sectors, for the most times such sectors are being financed from the oil reserves. Thus, when PSAs are signed by State, they lock the State in for a lengthy period and they freeze the State fiscal and financial policies. Still worse is when the State is running at a loss because of exploration by the FOCs as it is difficult to sustain the economy once the oil revenue is depleted[38] and this leads to the phenomenon referred to as Dutch Disease Syndrome[39] where the economy is being crippled by over reliance on one sector leading to poverty amongst States.

In the event of dispute between the FOCs and the States, the States are at a disadvantaged situation as only commercial matters are heard. Unfortunately, that States wanting to exert maximum control over their hydrocarbon resources opt for PSAs, but they do not always achieve their desired result looking at the experiences of some States, which have enthusiastically implemented PSAs and were disappointed by the end result.

3. PRODUCTION SHARING AGREEMENTS IN NIGERIA

Nigeria commenced its petroleum industry in 1908[40] and ever since Nigeria has developed different petroleum development contracts in view

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38 India de Soysa, 'The Resource Curse: Ane Civil wars Driven by Rapacity or Paucity? In, Nats Berdal and Malone (Eds), Greed and Grievance: Economic Agendas in Civil Wars (2000) Lynne Rienner Publishers, London.

39 *Ibid*

40 M B Umar, 'Legal Issues in the management of Nigeria's Production Sharing Contracts; from a study of the Nigerian National Petroleum Corporation (National Petroleum Management Services) Perspective' (2005) 1 OGEL 1.

to curing the deficiencies of the existing contractual arrangement or in response to the dynamics of the industry. Concessions were the earliest and only form of such contracts between 1908 and 1969[41]. The first Nigerian concession was granted to a German firm: the Nigerian Bitumen Company[42] and another in 1937 when Shell-BP was granted an exploration right pursuant to the Mineral Oil Ordinances No. 17, 1914[43] over the whole mainland of Nigeria comprising 357,000 sq. miles or 925,000 sq. kilometres for a period of 40 years (offshore) and 30 years (onshore) with an option to renew the contracts. The concessionaires were required to pay a yearly rent for the entire term of the concession and royalty, which would most often range between 5-10 shillings towards rent and royalty of 4 Shillings a ton of 2,240 lbs of Crude Oil.[44] These concessions have been criticised as being 'colonialistic' and exploitative of developing countries[45], and, in Nigeria, the PSAs were replaced by Joint Operating Agreements (JOAs).

JOAs were introduced pursuant to the Petroleum Act and Nigerian National Petroleum Cooperation (NNPC) Act to ensure State participation, among other things, in the development of Nigeria's petroleum resources through the abolition and conversion of all pre-1969 concessions to joint ventures with the FOCs[46]. Although there have been relative successes with the JOAs, its future was threatened between 1990 and 1992 following increased government's default to meet its cash call obligation to its partners[47]. This situation, according to Micheal Olorunfemi (1997)[48], was attributed to several factors including:

(a) A decline in the earnings from crude sales;

(b) Abolishing of crude oil dedicated accounts hitherto maintained by NNPC for the settlement of cash calls; and

(c) Non-availability of surplus cash for investment from internal sources. This had negative impact on the tempo of exploration and production activities to a point well below its potentials.

Faced with these challenges and the need to source the required finance to accelerate the tempo and scope of exploration and production activities in the deep offshore and Inland Basin Frontier areas, the government eventually adopted PSAs.

41 *Ibid*

42 *Ibid* p.22

43 Repealed by the Petroleum Act (1969) cap 350 LFN 1990.

44 Para 3(1) of the Concession Agreement of Shell BP in 1949 quoted in M.B Umar note 43, p.22

45 See the United Nations General Assembly (UNGA)b Resolution 1803 (xvii) on Permanent Sovereignty over natural resources; United Nations Charter of Economic Rights and Duties of a State; Resolution No. 90 of the 16th Conference of OPEC held on January 1968, which was re-emphasised in 1971 in a policy statement encouraging members to take necessary steps at controlling their oil industries and participating in existing concessions based on the principle of changing circumstances.

46 M B Umar note 43, p. 24

47 *Ibid*

48 Micheal A Olorunfemi, 'Oil and Gas joint Venture management; a Case for Reforms, Nigerian Petroleum Business, A Handbook. In VE Eromosele (Ed) 1997 68.

3.1 PSAs

PSA was introduced in Nigeria in 1973, in a contract between the Nigerian National Oil Corporation, the precursor of NNPC and Ashland Oil Nigeria Company for OPL 98/118 for duration of 20 years with renewal for another 5 years[49]. However, it was until 1991 when PSA was widely introduced, and the first rounds of PSAs were executed in 1993 with the second round in 2000[50]. Virtually all PSAs in Nigeria are on deep offshore and Inland Basin contract areas, although there are no legal restrictions against onshore or swallow water PSAs[51].

3.2 Nature of the Contracts[52]

The contract is a blend of statutory predetermined and contractually negotiated terms between the NNPC and the FOCs. Areas predetermined by the legislation include the government participation, title to petroleum, commerciality, licenses and mining leases, taxation, investment tax credits/allowance, ring fencing, domestic obligations, environmental protection and safety, training of Nigerian personnel, local content, arbitration and applicable law. Areas subject to negotiations include duration, work commitment, relinquishment, insurance, title to equipment, certain rights and obligations of the parties, composition functions and power of the management committee, bonus payments, cost recovery limits, production sharing, accounting procedure, lift obligations and project implementation procedure.

- The NNPC holds all rights in and to the contract area.
- The NNPC appoints the company as a contract with an exclusive right to conduct petroleum operations in the contract area.
- The contract permits the contractor to operate for 30 years: 10 years exploration phase, and 20 years oil mining lease (development/production) phase.
- The contract mandates the contractor to provide funds and guarantees and bears the risks operating cost.
- The contract requires contractors to employ and train Nigerian and encourages local content utilization as a means of achieving technology transfer.
- There is no cap on cost recovery as the contractor is allowed to recover all its operating expenses within 5 years and take an agreed percentage share of the profit.

3.3 The Structure of Nigerian Petroleum

The Nigerian petroleum industry is structured around four key components comprising, the legal framework as its foundation, the regulatory and administrative structure, duly empowered to give effect to

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[49] M B Umar, note 43, p. 13
[50] *Ibid*
[51] *Ibid*
[52] M B Umar, note 43, p 29

the legal provisions, the non-governmental key players and stakeholders, comprising the FOCs indigenous oil companies and, in recent times, the host communities and non-governmental organisations, and, lastly, the various petroleum development contracts and arrangements, which in combination with the relevant legal and regulatory regimes, governs the operations of the industry and the relationship between the parties[53].

3.4 The Legal Framework

There are several laws that are applicable to the upstream and downstream sectors of the Nigerian petroleum industry; however, the key legislations applicable to the upstream sector include:

- The Constitution of the Federal Republic of Nigeria 1999, particularly section 44(3), which vests ownership of petroleum resources in the federal Government of Nigeria and, thus, forming the bases of the Nigerian PSAs.
- The Petroleum Act, cap 350 Laws of the Federation of Nigeria (LFN) 1990, together with the Petroleum Regulations, Petroleum (Drilling and Production) Regulations and Petroleum Refining Regulations.
- Nigerian National Petroleum Corporation (NNPC) Act, Cap 320 LFN 1990.
- Petroleum Profits Tax Act (PPTA) as amended, Cap 354 LFN 1990.
- Oil Pipelines Act, cap 338 LFN, 1990 together with Oil and Gas Pipelines Regulations 1995.
- Deep Offshore and Inland Basin Production Sharing Contract Decree (1999).

Although these regulations are enacted for specific objectives, they sometimes overlap. However, the broad objective of these legislations has been summarised as follows:[54]

i. Assertion of national sovereignty over Nigeria's petroleum resources together with effective control and surveillance of petroleum operations by or on behalf of the federal government.
ii. The provision of increased revenue to the federal government.
iii. Supply of domestic needs of petroleum products.
iv. The acquisition of technology by Nigerian citizens and the development of indigenous manpower.

Despite the advantages of the PSA, there remain serious questions as to whether the existing provisions of the contract as they are. The challenges of implementing the contract do not constitute or are not likely to constitute serious impediments to the realisation of key national objectives for adopting the contract, such as the maximisation of revenue, protection of the environment, transfer of technology including local content utilisation/capacity building, recruitment and training of Nigerians.

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53 *Ibid* p. 13

54 Martin M Olisa, 'Overview of Nigerian Petroleum Industry' (2001) p. 2.

4. FINDINGS FROM NNPC WITH IMPLEMENTATION OF PSAs

From the study carried out by M. B Umar[55] at the legal and insurance department of NNPC/NAPIMS Lagos, Nigeria from April 2004 to September 2004, which focused on the key legal and contractual issues in the management of PSAs from 1993 to 2004 from the perspective of NNPC/NAPIMS, revealed that the NNPC/NAPIMS have been faced with many legal issues and challenges many of which are attributed to the inelegant and apparent deliberate ambiguities prevalent in the provisions of the contract particularly in the 1993 PSC.

These inadequacies legal and contractual provisions have raised many issues in the management of the contract and often with serious implications on the economics of a contract, the efficient and transparent execution of agreed work programmes and other obligations of the contractor and the relationship of the parties. These issues are categorised as follows[56]:

a) Those relating to the interpretation of certain provisions of the Petroleum Act, other relevant laws, and PSAs; and falling under this category are issues relating to:
    i. The relinquishment of the contract area
    ii. The application of back-in rights
    iii. The development of natural gas
    iv. Cost recovery under the 1993 PSA-consolidation versus ring-fencing
    v. The treatment of capital allowance, and
    vi. The deduction of Home Office overhead charges
b) The second category deals with the contractor's (FOCs) non-compliance with its obligations as to:
    i. Transfer of technology including:
        a. the employment and training of Nigerians
        b. utilisation of local content
    ii. Environmental obligations
    iii. Financial accountability.

It is rather disheartening to know that the issues listed above are eventually all the objectives the State (Nigeria) seeks to achieve by the implementation of PSAs and worse still is that the sorry state of affairs can partially be attributed to the government's negligence in drafting comprehensive contracts and legal frameworks, thereby, creating opportunity for the FOCs to exploit the loopholes to their advantage.

[55] M B Umar, note 43 p. 6
[56] *Ibid* p. 9

5. ISSUES RELATING TO THE INTERPRETATION AND APPLICATION OF SOME LEGAL AND CONTRACTUAL PROVISIONS

5.1 Relinquishment of Contract Area

The question here is whether more than one Oil Mining Lease 'OML'[57] should be granted where the 1993 PSA contractor has discovered more than one commercial field in the un-relinquished part of a contract area. The first schedule to the Petroleum Act 1969[58], and the Petroleum (Drilling and Production) Regulation[59], provide for the relinquishment of contract area. The PSC[60] also provides for the exclusion on contract, but somewhat differently. Paragraph 12(1) provides that 10 years after the grant of an Oil Mining Lease, one half of the area of the lease shall be relinquished. Paragraph 19 states that the shape and size of the area to be retained and of the area to be relinquished shall be approved by the minister. Paragraph 2(4) of the Drilling Regulations further provide that where there is provision for the relinquishment or surrender of part of the relevant area of a licence or lease, the relinquishment or surrender shall be such that the retained part is a compact unit as provided under Paragraph (2) and (3). Paragraph (2) provides that the area applied for shall be a compact unit not exceeding in area:

a. in case of oil exploration license on5000 sq. miles.
b. in the case of an oil prospecting license on 1000 sq. miles.
c. In the case of Oil Mining Lease on 500 sq. miles.

Paragraph (3) states that all Mining Lease deriving from oil prospecting license shall be in compact blocks of unit; and where more than one block or unit is derived, each block or unit shall be subject to a separate and distinct lease. Clause 4 of the 1993 PSC on the other hand provides that, not later than 10 years from the effective date, fifty percent (50%) of the Contract Area shall be excluded. The 50% of the Contract Area to be excluded shall be agreed by both parties and shall not include any part of the Contract Area corresponding to surface areas of any field in which petroleum has been discovered in commercial quantity.

These provisions can produce several and conflicting meanings leading to interpretative issues between the corporation and the FOCs. Some of such meanings include.

- Whether the aggregate of the area to be retained by the contractor comprises the 50% retain exploration area, plus the area corresponding to the surface area in which petroleum has been discovered in commercial quantities; or
- Whether there is anything in the regulations preventing the corporation from applying to the Minister for re-issuance of more than one single licence on the retained part of the Contract Area

[57] Herein after referred to as OML
[58] Paragraph 12 and 19
[59] Paragraph 2
[60] Clause 4

where the contractor has discovered more than one commercial field in the Contract Area.

The second issue above assumed significance after huge discoveries like that of SHELL's Bonga[61] and Chevron Texaco's Agbami covering more than single fields. Contractors expected the corporation to apply for more than one OML from the un-relinquished part of the Contract Area. The corporation argued, however, that granting more than a single OML on the retained Contract Area will give undue advantage to the contractors, since they already enjoy a very good profit split ratio of 80% to government's 20% under the contract[62].

In addressing the issues, Government of Nigeria passed the Oil Prospecting Licence (Conversion to Oil Mining Leases etc.) Regulations 2003, which essentially amended both the Regulations and the PSA by limiting the number of OML to be granted to no more than one OML at a time on a given Contract Area.

5.2 Computation of Home Office Overhead Charges

The 1993 PSA[63] provides that the contractor shall include the following percentage on the total annual capital expenditure as Home Office overhead charges in calculating total operating costs:

- First $200 million	1.00% of CAPEX
- Next $200 million	0.75% of CAPEX
- Next $100 million	0.5% of CAPEX
- Above $500 million	0%

Capital expenditure is defined as "expenditure which are subject to capital allowance under the PTT Act and such expenditures normally have a useful life beyond the year incurred"[64]. Such expenditures are listed in Paragraph (a) to (f). Some of the expenditures mentioned in Paragraph (e) are "pre-production expenditures all cost (including those otherwise falling with non-capital cost described in Paragraph 1 of this Article II) incurred before the first PTT accounting period".

This provision is ambiguous, and it is raising question for determination between the corporation and the FOCs on the interpretation of the phase "all cost (including those otherwise falling within non-capital coast described in paragraph I of this Article II) incurred before the first PTT accounting period". Does this mean:

a) All pre-production expenditures comprising those listed under capital costs and non-capital cost? Or

[61] The Bonga field lies a hundred and twenty kilometres off the coast of Nigeria, in water more than a thousand meters deep, and is estimated to contain reserves of more than six hundred million barrels of oil, along with abundant natural gas. The SHELL Nigeria Petroleum development corporation is developing the field on behalf of NNPC. SHELL's joint venture partners are ExxonMobil, AGIP and ELF.

[62] M B Umar, note 43, pg 56.

[63] Clause 13.3

[64] Article II, paragraph 2 of the accounting procedure (Annex B)

b) Pre-production expenditures listed as capital costs and those not listed as non-capital costs?

The issue arose when the corporation realised that the contractors had been including pre-productions costs-intangible drilling costs, geological and geophysical costs, appraisal and development wells as capital cost in computing home office overhead charges.[65] The corporation claimed their action was based on their interpretation of the above phase which was, pre-production costs "falling within non-capital costs are to be treated as capital costs for which they are entitled to add the home office overhead charges stipulated in Clause 13".[66]

The corporation disagreed with the interpretation, contending that the contract does not allow the treatment of these pre-production expenditure as capital costs in calculating head office overhead charges because.

a) Intangible drilling costs, and geological and geophysical costs are specifically listed in Article II K, L, and N as non-capital costs which are chargeable to the current year's operations

c) If the intention of the contract were to treat such costs as capital cost, it would have been listed.[67]

The corporation has expunged this anomalous clause from the 2000 PSA.

5.3 Issues Relating to Contractor's Compliance with The Provisions of the PSA

It is a universal principle of contract that a party to a contract is strictly bound by the contractual obligations without which the contract, no matter how well written, is but a worthless paper. This section examines the extent of the FOC's non-compliance with some key provisions of the contract and identify the key loopholes in the contract that contributes to the non-compliance.

5.4 Transfer of Technology

The transfer of petroleum technology has been defined as:

> "The ability of the developing country to purchase or hire in the international market, the most advanced equipment for exploration and development of its petroleum resources at a fair and reasonable cost. Above all, it should also mean developing its human resources by enabling its citizens to acquire the mental capability and practical experience needed to comprehend the mysteries of modern technology and to manipulate the sophisticated tool" …[68] "As a first step, therefore, countries must be able to attract required skill and process from the international market for energy technology. At the same time, the local based

[65] M B Umar, note 43 p. 69
[66] *Ibid* p. 70
[67] *Ibid*
[68] Kameel Hassan, 'The transfer of technology and Petroleum Development in the Developing Countries: with special reference to Trinidad and Tobago' (1986) 4:1 JERRL 11.

> absorption of ideas should be developed to the point where, with time, the total size of the imported package is reduced. An effective transfer, then, requires that the country reduces its dependence on imported technology with industrialisation"[69].

From this definition, some salient points can be drawn which includes the development of human resource, and industrialisation as a means of reducing or eliminating dependence on the imported technology. The governments have tried to address this issue through appropriate policies and legislations by creating obligations in the PSAs for the FOC like the recruitment and training of Nigerians, the training of corporation's personnel, and local content utilisation. The question is how have FOCs fared in carrying out these contractual obligations.

5.5 The Recruitment and Training of Nigerians

The Petroleum Act of 1969[70] and the 1993 PSA[71] and a similar provision in the 2000 PSA provide that the contractor is obliged to employ qualified Nigerians for all non-specialised positions such as those in exploration, drilling, engineering, production, and finance. The contractor is allowed to employ expatriates only when there are no Nigerian and shall train Nigerians for such specialised positions such that the number of non-Nigerian staff shall be kept to a minimum. The FOC is also required to train other Nigerians who are not its employees under scholarship and industrial training schemes, among others. The PSA[72] also requires that contractor to accept the staff corporation on industrial or work experience programme on non-discriminatory terms. To ensure compliance, the Petroleum (Drilling and Production) Regulations[73] requires the contractor to submit for the Minister's approval, a detailed annual programme for such training and progress thereof.

In spite of these provisions, the contractors do not fully carry out their obligations. The President, speaking at the inauguration of the local content committee in April 2004, was reported to have lamented that 50 years since the discovery of oil in the Niger-Delta, upper management in the Nigerian oil industry are still essentially expatriates.[74] This situation can be attributed to the contractor's violations such as AGIPs' unwillingness to accept NPDC's personnel seconded to work with its officials on OPL 244[75], contrary to its obligation under clause 12.4, continued employment of expatriates of the disadvantage of Nigerians and refusal to make any succession plans or circumvention of such plan through re-arrangement of duties or qualifications. An example is the distribution of personnel to SHELL Nigeria, where the records obtained from NAPIM's planning department, show that

69 *Ibid*
70 Paragraph 37 of the schedule thereto
71 Clause 12.3 and 7.1 (j)
72 Clause 12.4 (1993)
73 Regulation 26 – 29
74 10:3271 THISDAY Newspaper Nigeria 2004, Tuesday April 2004.
75 M B Umar, note 43, p.73

out of a total staff strength of 384 expatriates disproportionately hold 136 positions (35.4%) to Nigerians 284 (about 65%), and of this number, 17 expatriates still occupy middle level management and senior staff positions, which should have otherwise been occupied by Nigerians by direct posting or succession arrangement[76].

These recurrent violations can be attributed to the existence of loopholes in the agreements making it easier for contractors to circumvent these obligations and the absence of specific sanctions for non-compliance, except perhaps, the unlikely refusal to grant work permit, thereby, leaving the decision on the actual employment and the training thereof, entirely with and at the discretion or convenience, thereby, making a mockery of the entire government objective. This may be the reason that Adams lamented that "There is little technology transfer happening in Nigeria petroleum industry and that it is just not part of the mission of oil companies to transfer technology"[77].

5.6 Local Content

The requirement for the utilisation of Nigerian human and material resources by the contractors is embodied in many provisions of the PSA[78]. The focus of local content, therefore, is:

1) the development of local fabrication yards
2) ring fencing of special EPC contracts for wholly indigenous companies
3) domesticating major studies in Nigeria
4) domesticating the conduct of front-end engineering design (FEED) in Nigeria[79].

The question again is, "have the contractors fully complied with the provisions of the contract in line with the objectives of the local content policy"? An answer to this question should be reasonably measured against the "indicators of achievement" set by the corporation[80].

i. Service companies having considerable share of expenditure and moving from low-tech to high-tech jobs in the industry.
ii. Indigenous oil exploration companies having technical competence and capacity for high production levels.
iii. Core competences and jobs categorisation that builds large resource pools in:
    - Exploration and associated services
    - Drilling/drilling services
    - Petroleum engineering

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76 *Ibid* p. 74

77 G. Aret Adam (Late) was a Managing Director of NNPC and a doyen of the Nigerian Petroleum Industry. Quoted in Afolabi Oladele, Rethinking Petroleum Policy in Nigerian Petroleum Business, A Handbook (1997) V.E. Eronmosle (Ed), p. 93

78 Particularly Clause 7.1(i) Section 1.3(f)(g) and 2.3 of Annex E (project implementation procedure).

79 NAPIMS, local content in the Oil and Gas Industry Presentation to the Presidency (2003).

80 *Ibid*

- Engineering designs
- Quality, Health, Safety and Environment (QHSE), fire security etc.

Measure against the above "indicators of competence", the performance of the contractors as regards compliance with local content utilisation is far from desirable. In the words of the former Managing Director of the corporation "the principal concern today is that all the efforts put in over the years to promote effective Nigerian participation in the industry have all failed to achieve the desired goal"[81].

This is corroborated by the records obtained from NAPIM's planning department indicating that out of the 349 contracts valued at $4.8 billion awarded to the contractors in 2003, only 141 or 40% of the contracts valued at $67.7 million (14%) were awarded to local contractors, while the remaining 208 contracts (60%) valued at $4.1 billion (86%) were awarded to foreign contractors.[82] Despite these setbacks, the government has, in the past couple year, unveiled an apparent comprehensive local content policy aimed at achieving 40% local content by 2005, and 60% by 2010, "through well-articulated strategic alliances/partnering and increased participation"[83].

5.7 Financial Accountability

The maximisation of return on petroleum investment through efficient and transparent mechanism is one of the corporation's key goals in the management of the PSAs. The legal framework for this is contained in various provisions of the contract on such issues as:

a) the review and prior approval of work programmes and budgets,
b) the implementation by the contractor of the provisions of the accounting procedure (Annex B), the lifting procedure (Annex D), and the procurement and project implementation procedure (Annex E) and all amendments thereto agreed by the parties, and
c) periodic audit of the work programme to ascertain that:
    i. the expenditures were validly and properly authorised in accordance with the relevant legal and contractual provisions,
    ii. that they have been carried out efficiently and transparently, and
    iii. that they were within industry standards.

Information gathered by M. B. Umar[84] from the review of several account and audit reports, minutes of some management and technical committee meetings and the deliberation of the meetings of such committees personally witnessed all indicate regular violations of some of the above contractual safeguards. Some of the violations include execution of work programme outside approved budget, poor reporting of drilling expenditures, poor accounting for bank transactions, over estimation of

81 G. Aret Adam, note 79
82 NAPIMS, local content in Oil and Gas Industry, note 81
83 *Ibid*
84 M B Umar, note 43, p. 91

capital expenses and the treatment of certain pre-production expenditures as part of capital expenditure for the purpose of computing head office overhead charges etc. For example, the records obtained from PSA accounts unit of NAPIMS showed that from the cost verification exercise carried out on three companies in 2000 and 2001, the companies were found to have overstated their operating expenses by thirty-six million, seven hundred and fifty-nine USD ($36,759,000)[85], which gives a possible indication of what to expect from other companies.

These violations can be attributed to a lot of factors, one of which is the fact that PSAs do not give the corporation enough powers to sanction the contracts for many of their violations and even where the corporation is empowered to sanction the contractors, the provision is usually full of deliberate ambiguities and exceptions, which renders the sanctions unenforceable or ineffective, thus, making it possible for contractors to avoid appropriate sanctions[86]. Under the provision of both the 1993 and 2000 PSA, the corporation is entitled to two remedies against an erring contractor, namely termination and indemnity[87].

It is pertinent to say that despite the amendments of the PSAs and relevant legislations, the government is not satisfied with the results of PSAs. Further on the 7th of June 2009, the Special Adviser to the President on Petroleum Matters, Professor Emmanuel Egbogah, told Irish investors that the Federal Government had embarked on the unbundling of the NNPC to transform it into an integrated, international commercial oil and gas corporation "driven by revenue"[88]. The FOCs are opposed to the policy shift contending that to begin renegotiation on existing contracts signed many years ago would not only constitute a breach but can affect future investments in oil and gas projects[89].

Although the Minister of Petroleum Resources, Dr. Rilwanu Lukman, had recommended the review and renegotiation of existing PSAs signed with the FOCs, stating that the oil contracts in place provide for periodic review and renegotiation, 'THISDAY' learnt from industry sources that the real reason for the review was because the PSAs, as they are, do not favour Nigeria as the multinationals "cart" away greater part of the oil revenue, leaving the country with just a token[90].

The Bill to unbundle NNPC, known as "the Petroleum Industry Bill", was introduced in 2007 and has passed its first and second reading at the National Assembly[91]. To review the PSAs, Dr. Lukman on the 4th of August 2009 said, "the PSAs in place were negotiated 10 to 20 years ago and that

85 *Ibid*
86 *Ibid* p. 92
87 Clause 3.2(a) 1993 PSA and Clause 19.1, 2000 PSA
88 Chika Amanza-Nwachukwu, 'Nigeria: Lukman – No Going Back on review of Oil Contracts' THISDAY Newspaper Nigeria, <http://allafrica.com/stories/200908040172.html> accessed 8 August 2019.
89 *Ibid*
90 *Ibid*
91 THISDAY Newspaper Nigeria, note 90.

things have changed since then, and the prices of oil went from less than $10 to $180 per barrel and you expect that we should keep the same law? Naturally, we have to review the provisions and put them in line with current situations not just for our own interest but in the interest of our partners and those who want to come in"[92].

The benefit of the reform, according to Dr. Lukman, is to put the industry on a better level and ensure that our industry can compete favorably and competently with other similar industries in the world and our regulatory bodies are in shape and at the end of the day. The people will benefit maximally from the resource(s) exploitation in the years to come[93]. Although the government's action is intended for the protection of its nationals and public policy, consideration should be given to the stabilization clause, which is one of the major elements that attracting the FOCs to invest in PSA regimes. For today, the decisions may be favourable but, in the future, FOCs may not be willing to invest because of fear of dealing with a nation that does not honour its contracts. It is one thing to opt for a regime and it is another to go by the dictates (policies) of such a regime, whether favourable or not.

5.8 Production Sharing Agreement in Russia

In December 1993, President Boris Yeltsin's presidential decree established the basic regulatory framework for PSAs.[94] The Sakhalin 11 PSA was signed in June 1994 and in 1995, the Duma State passed legislation granting PSAs the status of legally binding contract and establishing the basic provisions of the international standards.[95] The Kharyaga and Sakhalin 1 PSAs were signed later that year[96], and in 1999, the Duma passed legislation harmonising the 1995 PSAs with the existing Russian laws in an attempt to attract additional international investment in flagging Russian oil and gas (O&G) industries.[97] Duma has approved 29 O&G projects for development under PSAs, only three grand-fathered PSAs (Sakhalin 1 & 2 and Kharyaga) are in operation.[98] Although there has been some achievement from the 1995 PSAs, which have been amended twice, the practical is still wanting.

92 Chika Amanza-Nwachukwu, 'Nigeria: Lukman – No Going Back on review of Oil Contracts' THISDAY Newspaper Nigeria, <http://allafrica.com/stories/200908040172.html> accessed 8 August 2019.

93 *Ibid*

94 Timothy Fenton Krysiek, 'Agreements from Another Era; Production sharing Agreements in Putin's Russia, 2000-2007' (2007) 34 Oxford Institute for Energy Studies1.

95 *Ibid*

96 *Supra*

97 Paul Chaisty, 'Legislative Politics and Economic Power in Russia' (2006) Basingstoke, England: Palgrave Macmillian in Association with St. Antiny's College, p. 174-77

98 O. O Rewane, 'Creating a Comprehensive and Investor Friendly PSAs REGIME: Where Does Russia Keep Going Wrong?' (2005) 3 OGEL 3.

5.9 Sakhalin II

The Sakhalin II Project is an example of how the PSA mechanism in Russia is supporting the country's largest single investment project. Signed in June 1994, the Sakhalin II Project is the only project in Russia that is able to deliver gas to the target Asian markets in the near to medium future. The Sakhalin II Project will help increase Russia's credibility as an energy exporter in Asia, plus it paves the way for other future gas projects. Without a doubt, the Sakhalin II Project represents the first success model for the other PSAs in Russia and demonstrates, in practice, how a comprehensive and investor-friendly PSA regime can be used as a means of drawing large-scale investments into the energy sector[99].

The Sakhalin II Project represents many firsts in Russia. It is Russia's first offshore PSA, it is the first project to establish offshore development and production in Russia, and it's first non-recourse project financing in Russia[100]. Sakhalin-II contains approximately 1.1 billion barrel of oil and 684 bcm of gas and, according to Shell, Sakhalin-II is the largest integrated oil and gas project in the world[101], and it includes two major fields: the Piltun-Astokhsoye (PA) oil field (with associated gas) and the Lunskaye gas field (with associated condensate)[102].

The Sakhalin Energy Investment Company (SEIC)[103] constructed Sakhalin-II in two main phases. In phase one, they developed part of the PA field to secure an early flow of oil and to generate capital for phase two of the project and produced its first oil in 1999[104]. The initial cost of phase one was estimated at $600 and $780 million; however, the final cost of developing PA was $1.6 and $2 billion[105]. Phase two of Sakhalin-II includes new offshore drilling platform at PA and Lunkskoye and under water pipelines sinking them into the mainland and ensuring year-round production[106]. This phase has been far more complicated and expensive than phase one. SEIC's initially estimated cost was $8 to $8.5 billion but Shell, in July 2005, announced that the total cost for phase two was $10 to $22 billion.

5.10 Impact of Sakhalin-II on Russia

The Sakhalin-II PSA has met some of the expectations of the Russian party. However, there are some key features that are unacceptable to the Russian party. The duration of the contract is indefinite. The initial term of the Sakhalin-II PSA is 25 years, but the agreement contains an unusual clause that allows the SEIC to extend the PSA indefinitely and to continue

99 Supra n.4 at p.5
100 Andrew B. Seck, 'Production Sharing Agreements as a means of drawing large-scale investments into the energy mining and other sectors (an oil and gas industry perspective from Russia)' (2004) 12 CEMPLP Internet Journal 4
101 Timothy Fenton Krysiek, (note 96), p. 19
102 *Ibid*
103 Herein after referred to as SEIC
104 Supra
105 Ibid
106 Ian Rutledge, 'The Sakhalin II PSA – A Production 'Non-Sharing' Agreement' (2004) Sheffield Energy and Resources Information Service, p. 11.

extracting oil and gas from PA and Lunkskoye as long as the consortium deems the field to be 'economically practicable'.[107] The Russian party could appeal against the consortium's decision to extend the PSA but such an appeal will go to an international arbitration[108]. It is, however, difficult to see the Russian party win when the fields are still profitable.

From the Russian standpoint, the most objectionable aspect of the Sakhalin-II PSA is the agreement's production sharing formula[109]. Under the terms of a standard PSA, the investors receive the majority of early revenue in order to recoup the costs of exploration and development once the PSA has reached the cost recovery stage according to a pre-negotiated formula. The Sakhalin-II PSA uses a novel approach, which it calls the first level of Accumulated Net Cash Proceed (FANCP) and second level of Accumulated Net Cash Proceed (SANCP)[110]. The two indices are a device, which ensures that SEIC receives not just its investment costs, but also a comfortable rate of profit[111]. With these terms, the Russian party would only receive its share of profit oil once the SEIC partners recovered the cost of the Project and earned a 17.5% internal rate of return (IRR) on their investment[112].When Shell announced that the cost of the Sakhalin-II had increased to $22 billion, it meant that the SEIC[113] would receive nearly all the revenue from Sakhalin-II until they recovered $22 billion worth of capital investment and an additional $3.85 billion in profit[114]. In effect, it seems the Sakhalin-II PSA was designed so that the Russian party would suffer disproportionately in the event of any major cost overruns and considering Shell's 2005 cost estimate, it would take a decade of production of Sakhalin-II before the members of the SEIC recovered their costs and designated Internal Rate of Return.

Considering the inflationary pressures affecting the cost of upstream oil and gas projects around the world, it is not amazing that the Sakhalin-II budget exceeded its initial projection although the increase is quite alarming. However, from the Russian perspective, the terms of the Sakhalin-II PSA have exacerbated the impact of external economic forces by allowing the consortium to claim excessive recoverable costs[115]. A standard PSA includes 'cost caps' to ensure that if a project runs over budget, the State will receive some revenue from the fields' early production, rather than being forced to wait until the cost recovery stage for its share of profit oil[116]. Cost caps ensure that the risk associated with cost overruns is shared between investors and a

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[107] Sakhalin PSA, 1994, Sec. 3 C(i), p. 17-18.
[108] CEE Bankwatch Network and others, 'The Sakhalin II PSA-Production 'Non-Sharing' Agreement Analysis of revenue Distribution' (2005) OGEL I 15.
[109] *Ibid*
[110] Rawi Abdel,*'Journey to Sakhalin:Shell in Russia'*, Harvard Business School 2004
[111] CEE Bankwatch Network and others, 'The Sakhalin II PSA-Production 'Non-Sharing' Agreement Analysis of revenue Distribution' (2005) OGEL I 15.
[112] *Ibid*, see also Gazprom, 'Sakhalin Energy Working to Repair Eco- Damage on Sakhalin II', RIA Novosti, 21 Feb 2020.
[114] Ilya Klebanov, 'A Region of strategic importance' (2007) 1 Oil of Russia; The Russian Barent Sea Region Towardss 2015 (Delft, The Netherlands: Elburon, 2004) 44-47.
[115] Bjorn Brunstad, 'Big oil playground, Russia Bear Preserve or European Periphery'
[116] 'Sakhalin: that sinking feeling', Startfor, 21 Feb 2006.

State[117]. The Sakhalin-II PSA contains no annual cost caps, and it also grants the SEIC considerable discretion to determine which expenditure are recoverable costs[118]. According to the terms of the Sakhalin-II PSA, the members of the consortium must pay a royalty tax of 6% on gross revenue and a profit tax of 32% on all oil and gas produced at Sakhalin-II[119].

In a standard PSA, the average royalty is 10-20% and the profit tax of 32% is 3% lower than the Russian tax rate at the time the PSA was signed.[120] Shortly before the Gazprom acquired a control of Sakhalin, Minister of Natural Resources, Sergei Fyodorou, claimed that, with a market price of $60 per barrel, a typical profit tax of 50-55%, the Russian government would receive $300-$400 million per year from[121] the project rather than just $20 million[122].

The major contention between the Russian government and SEIC over the Sakhalin-II was the project's escalating cost and its environmental violation[123]. For the Putin administration, the steadily rising cost of the Sakhalin-II project and Russian party's ever-lengthening wait for profit oil made the terms of the PSA not only unfair but unacceptable and that gave the government a reason and a pretext to intervene against the SEIC and alter its management and ownership[124]. A few years ago, the National Audit Office of the Russian Federation calculated that the State would lose some $50 billion for the total period of the PSAs for Sakhalin-I and Sakhalin-II as compared to a tax and royalty regime for the same project[125]. It seems the Russian government is not getting what it bargained for with intended revenue and control from the PSA. Outside the fact that the FOCs can manipulate the contract to suit their 'whims and caprices', the Russian government is not off the 'hook' with regards to its framework.

Although the PSA is aimed at producing economic certainty and numerous tax concessions designed to attract the FOCs, the legal structure of the PSA heavily favoured the consortium, facilitating cost overruns and substantially delayed the Russian party's share of the profit oil[126]. The existing tax laws and other laws were not to accommodate the PSA and, as a result, there was serious concern that the investor receiving PSA contracts might be subject to existing "ordinary" tax and other laws[127]. It is, however, noteworthy that an exemption from regional and local taxes may only be

117 Juri Tjuljubaev, 'Russian Oil Transit-Way to the North' Barents Observer, 14 April 2004.
118 *Ibid*
119 Jonathan Stern, as quoted by Jeremy Bransten, 'Russia Energy Analyst Looks at Sakhalin-2 Takeover' Radio Free Europe/radio Library, 22 December 2006.
120 *Ibid*
122 *Supra*
123 Ian Rutledge, 'The Sakhalin II PSA – A Production 'Non-Sharing Agreement' 3.
124 Russian Oil & Gas Report, *Federal Energy Agency to Revive Production Sharing Agreements* (2004).
125 J. Hines & A. Bardin, *Tail Whacks Dog: Few PSAs Can Go Forward in Russia* (2004).
126 A.S. Kim & A.G. Svistel'nikov, *On the New PSA Tax Regime: Oil, Gas and PSAs* (2004).
127 Hober, K., 'Russian PSA-Quo Vadis?' (2005) 2 OGEL 1.

granted to an investor, provided the regional and local tax legislation agrees to such exemptions for PSA participant[128].

On the whole Russia has been grossly cheated because the PA and Lunskoye fields were already discovered by the Russian companies and as such the initial element of risk was removed from the outset.[129] SEIC took advantage of the weakness and ignorance of the State. However, PSAs seem to have reached the end of the road in Russia because, in recent times, the Russian government has systematically destroyed Yukos, built-up State-owned O&G champions Rosneft and Gazprom and restricted foreign investment in Russian hydrocarbon projects.[130] In 2003, President Putin also signed legislation that greatly reduced the number of O&G fields eligible for development under PSAs and adjusted the federal tax code to make future PSAs less attractive to foreign investors.[131]

6. REASONS STATES DO NOT ACHIEVE THEIR DESIRED RESULTS/ RECOMMENDATIONS

Despite the advantages that PSAs portray to the States, most States still have difficulties achieving their desired results. Some of the defects that are inherent in PSAs are discussed below:

6.1a Stabilization Clause

This is a fundamental clause in the PSA, which is used by the States as an incentive to attract investments from the FOCs by providing investment stability and predictability for them because PSA is a sole risk contract for the FOCs.[132] The clause also acts as a form of guarantee between the investor and the project leaders who need an assurance of investment stability and predictability.[133] Ironically, this very useful clause has a negative effect on the State because the FOCs capitalise on it to allocate certain risks such as tax or legislative change to the State oil company.[134] In other words, if tax is increased, the State oil company pays, not the FOCs. The clause also gives precedence to the PSA over existing and future law (except the Constitution)[135] such that once the conflicts arise, PSA prevails. An example is the case of Baku-Tbilisi-Ceyhan pipeline in Georgia, where the State was requested to violate its own environmental law by British Petroleum.[136]

128 Coudert Brothers, New Development in Russian PSAs & Subsoil Legislation (2004).
129 CEE Bankwatch Network and others, note 14 p. 15
130 Timothy Fenton, note 96 p.3
131 *Ibid*
132 Margarita T B Coale, 'Stabilisation Clauses in International Petroleum Transactions' (2020) 30:2 Denver J International Law and Policy 217-221.
133 B. O. N. Nwete. '*To What Extent can stabilisation clause mitigate the investors risk in Production Sharing Contracts?'* (2005) 1 OGEL 15.
134 Greg Muttilt note 16, p. 12.
135 *Ibid*
136 Nino Chkhobadze, Georgia Environment Minister, November 2002. The Minister refused to approve the pipeline routing through an important National Park, as this would violate Geeorgia's environmental laws. But the minister was forced to concede because Georgia had signed an agreement for the project which got it a higher status than other Georgian laws.

The constrains on the State are quite numerous because investment in Petroleum Exploration and Production (E & P) is based on reasonable speculation and assumptions[137] and this could take a long period. For example, the Equatorial Guinea PSA has an E & P period of 42 years.[138] This makes the PSA vulnerable to events which may alter the initial projections and assumption upon which negotiations were based[139]. For instance, the acreage may turn out more profitably than envisaged and the State, which 'has the duty to preserve contract benefits to itself and to others[140] cannot, by reason of the stabilisation clause, contract itself out of its obligations even in the event of a windfall.

It is apparent that the undue influence that the State is trying to avoid is what often occurs when PSAs are applied and all these calls to question the regulatory powers of the State as a sovereign to effect changes in the PSAs and it contradicts the saying 'what the parliament giveth, the parliament may taketh away'.[141]

6.1b Recommendation

A solution to the issues from stabilisation clause is the inclusion of a renegotiation clause in the PSA. This gives the parties an opportunity to salvage a contract, which would otherwise fail if there was no opportunity to renegotiate the original terms of the contract and adopt it to a change in law, regulation or other circumstances.[142] This clause should, however, be drafted with caution because it has its own limitations, which depends on the nature of the renegotiation clause i.e., if the renegotiation clause is specific, only those specific events will trigger off renegotiation, and if it is a general renegotiation clause, it will encourage the parties to ask for renegotiation on flimsy grounds, thereby, jeopardizing the stability of the contract.[143] The best approach is to draft the general renegotiation clause, which makes renegotiation subject to a distortion in the financial or economic equilibrium of the contract caused either by time element or by a change in fiscal or legal regime[144] this way, renegotiation on flimsy ground is highly reduced. To give renegotiation clause some measure of predictability and stability, a time limit within which the renegotiation must produce results should be stated, failing on which a dispute must be declared.[145]

137 B.O.N Nwete note 2 p. 16
138 Art 2.1, 2.2 and 5.11 of Equitorial Guinea Model PSC
139 Walde T. Kolo A, 'Renegotiation and Contract adaption in international investment projects: Applicable Legal Principles and Industry practices' (2003) 2(1) OGEL 3.
140 B.O.N Nwete note 2 p. 16.
141 Johnston D., 'International Petroleum Fiscal System and Production Sharing Contracts' (1994) Tulsa, Oklahoma USA: Pennwell Publishing Company, p.171
142 B.O.N Nwete, 'To what extent can renegotiation clause achieve stability and flexibility in petroleum development contracts?' (2006) IELTR 56-63.
143 *Ibid*.
144 *Supra*.
145 *Ibid*.

6.2a The Use of International Arbitration

PSA specify that any dispute between the government and FOCs should be referred to International Arbitral Tribunals such as ICC in Paris, ICSID in Washington DC[146], etc. The rationale is that there is lack of judicial independence in most countries, which will be disadvantageous to the FOCs. In other words, the protection of the FOC is guaranteed and the State who owns the hydrocarbon resources is exposed to arbitral tribunals that are not dependable because the disputes are heard by corporate lawyers and trade negotiators who are more inclined towards commercial issues than issues of national interests.[147] Susan Leubusher captures the situation when she commented that 'the system assigns the State the role of just another commercial partner, ensures that non-commercial issues will not be aired, and excludes representation and redress for populations affected by a wide-ranging power granted (multinationals) under international contracts.'[148]

6.2b Recommendations

Disputes should be heard within the State and under their law. Moreover, the PSAs are subject to domestic law with minimal compliance with international treaties.[149] However, for fair hearing and protection of the FOCs, some international arbitrators who are abreast with the domestic law should be a part of those hearing the dispute.

6.3a Complexity of PSAs

PSAs are the most complex form of oil contract, and they consist of several pages of technical legal and financial language.[150] This complexity favours FOCs as the "devil" is usually in the midst of the details. Royalty is the simplest form of oil policy where the company pays the State for its oil[151] but the FOCs prefer PSAs because it is based on an assessment of profit.[152] The reason is that they want 'upside' (that is, opportunities for greater profit) and ways they can reduce their payments.[153] Hence, they depend on complex rules for which cost can be deducted by using sophisticated accounting technique with access to the world's largest and most experienced accounting companies.[154] In addition, the FOCs know their business in more details than the State they are working with. For example in the Sakhalin II PSA Project in Russia, SEIC took advantage of the complex terms of PSA by using a novel approach it calls the FANCP[155] and SANCP[156] index, which

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146 Greg Muttitt note 38 p. 24
147 *Ibid* p. 25
148 Susan Leubuscher, '*The Privatisation of Justice: International Commercial Arbitration and the redefinition of State: MRES Thesis'* Birkbeck College 2 June 2003.
149 Bernard tavern, note 19 p. 54
150 Greg Muttitt note 38 p. 25
151 *Ibid*.
152 Bernard Tavern, note 19 p. 44
153 Greg Muttitt note 38 p. 25
154 *Ibid*
155 First level of Accumulated Net Cash Proceeds
156 Second level of Accumulated Net Cash Proceeds

resulted in all cost over-run being effectively deducted from the State revenue instead of the Shell-led consortium's profits.[157] In February 2005, the audit chamber of Russian Federation published a review of the economics of the terms of the PSA had already cost Russia $2.5 billion.[158] Another result of such complexity is that the State might think that it is getting a good deal when in reality it could be receiving less profit than they bargained. For example, when Chad signed a 'convention agreement' with neighbouring Cameroun and Exxon-led consortium in 1988 covering both the production sharing terms on Chad's Doba oil field and a pipeline through Cameroun to the coast[159], most commentators stated that the governments share was low till the government found itself receiving less than is expected.[160]

6.3b Recommendation

States should be very critical when drafting PSAs especially the financial aspect and they should not underestimate the intelligence of the FOC or even get carried away with the false hope of control that the PSAs theoretically provide the State. The States should consult professionals from developed countries which do not have an interest in the States' PSA, to scrutinise such draft to minimise or remove ambiguities and loopholes, which can be exploited by the FOCs.

6.4a Reliance on FOCs for the Training of State Personnel/ Inexperience of NOCs

PSAs stipulates that the FOCs should train and transfer technology to the State personnel and nationals.[161] They may be advantageous in the sense that that FOCs who are experts will help in establishing the developing countries. Sadly, the FOCs have not been complying with this aspect of the PSA.[162] On the other hand, it is not a wise idea for the FOCs to train the State personnel, because they are the ones exploiting the hydrocarbon resources of the State and since they have an interest, they will not do justice in training the nationals.

The FOCs will teach the States what they want the States to know and not what they ought to know. Although the State has authority, the FOCs are the ones in control because the State works with whatever statistics they declare and to further compound issues; the NOCs whose task is to supervise the FOCs are inexperienced not having the right calibre of staff and resources to carry out independent research. The reason for this attitude of the FOCs is lack of transparency and corruption in their dealing with the State.

[157] CEE Bank Watch Network et al, note 113 p 15
[158] Greg Muttitt note 38, p. 26
[159] Greg Muttitt note 16 p. 9
[160] World Bank Inspection Panel [Cameroun Investigation Report (No. 25734, Dated 2-05-03) Para. 39, PXVII]
[161] Bernard Taverne, note 19
[162] Nigeria and Russia

6.4b Recommendation

States should send out some of their personnel to acquire training and expertise from developed nation that do not have an interest in the States hydrocarbon resources. These trained personnel will in turn institutionalise their knowledge by training other personnel and nationals. Although this approach is expensive, in the long run the State will benefit as NOCs will effectively carry out its task of supervising the FOCs and have the right calibre of staff thus reducing to a large extent, the exploitation of the States by the FOCs.

6.5a Incomprehensive Legal Framework

Some States, in a haste to maximise profit from their hydrocarbon resources, do not align their existing law with their new oil policy (PSA). They either use the framework of a previous oil policy or leave loopholes and ambiguities in the legal and contractual framework.[163] It is sad to see that States worsen the issues in PSAs which are already bad enough. The FOCs took advantage of such flaws to exploit the State.

6.5b Recommendation

A comprehensive review and modification of the State laws and PSAs cannot be overemphasized as this is fundamental to the States achieving its result. As Hober[164] rightly opined, 'Russia cannot achieve results from PSA without amending its legislation and as such, Russian tax legislation had to be amended to incorporate and implement the tax regime foreseen in the PSA law'. States should adopt PSAs in ways which suit their specific economic and political interest by adopting the framework and content. Cyprus is an example of a State that adopted such framework not content.

6.6a Issues of Taxation

Sometimes States that implement PSAs are not in a very good position when the issue of taxation arises, because emerging market do not always have an effective taxation scheme, even though such revenue accounts for most of the State's budget, in comparison with their more developed counterparts. However, States can reduce profits made by the FOCs by introducing 'sliding scale'[165] and increase in profit.

6.6b Conflicting Interest

One reason the State may not be achieving its result in PSA is the difference in philosophy and unequal power.[166] The State is concentrating on public oriented goals and FOCs on financial reward when there should be a common goal.

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[163] Niger, Umar
[164] Hober note 100 p. 2
[165] Daniel Behn, 'Sharing Iraq's Oil: Analyzing production sharing contracts under the final draft petroleum law' (2007) 4 OGEL.
[166] M B Umar 43 p. 98

7. CONCLUSION

The economic and strategic importance of hydrocarbon resources have led states to establish their domestic petroleum production and, as such, many States are compelled to turn to the FOCs means needed for the exploration and exploitation of their petroleum resources. Open to the States are various options of oil policies; however, some States opt for PSAs as the vehicle for the development of their oil and gas resources. This is because PSAs provide for State sovereignty and control over its natural resources with an opportunity of transfer of technology and training of the State personnel by the FOCs while the FOCs bear the development and financial risk. However, the State has ownership of its natural resources, but control of the resource is with the FOC.

The State is dependent on the FOCs for training and transfer of technology; invariably they do not know what is going on. They depend on whatever statistics is given by the FOCs with regards to the hydrocarbon. For the most times, the FOCs do not comply with the transfer of technology and training because there is lack of transparency in their deal and, as such, they do not want to put the State on the-know. There are clauses in the PSAs, which expose the States and protect the FOCs. For instance, while the stabilisation clause is freezing the legal and fiscal policies of the States, it gives the FOCs investment predictability and stability because it is a sole risk contract for the FOCs. Also, when there is a dispute between the FOCs and the State, it is transferred to International Arbitral Tribunal where only commercial matters are held by ignoring issues of national interest. Again, the reason for International Arbitration is the lack of independence of the judiciary in a State, which may be disadvantages to the State.

PSAs are complex and, for the most times, the 'devil' is in the detail. The FOCs are favoured by complexity and, being the "masters of the game", they manipulate the terms to sooth their 'whims and caprices'; while the State is working with the terms of the PSAs, the FOCs are working with the intricacies, ambiguities and loopholes. This is evident in Russia, where the FOCs used the FANCP and SANP index to recover all its costs and profits before the Russian party. This was even more exploitative because SEIC did not have the initial risk element for the Russian companies, who had discovered the PA and Lunkskoye field before SEIC. This is not, however, to suggest that other forms of oil policies do not have their downsides, the bone of contention is the false appearance of control and sovereignty in the States over their petroleum resources when, in fact, the State is not really in control. Professor Walde, an expert in oil law and policy at the University of Dundee brings to light the naked truth of PSAs, described:

> "A convenient marriage between the politically useful symbolism of production sharing contract (appearance of a service contract to the state company acting as master) and the material equivalent of the model with concession/licence regimes in all significant aspects………… government can be seen running the show and the

company can run it behind the camouflage of legal title symbolising the assertion of legal national sovereignty".[167]

Based on the afore mentioned, it is submitted that States who want to exert maximum control over their hydrocarbon resources opt for Production Sharing Agreements, but they do not always achieve their desired result.

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